APPENDIX A

IN THE

United States District Court

SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

CIVIL ACTION NO. 65-H-30

HOMER L. BRUCE, Plaintiff,

v.

UNITED STATES OF AMERICA, Defendant.

Memorandum:

On January 15, 1965, plaintiff, Homer L. Bruce, filed suit against the United States of America for the refund of income taxes paid under protest by plaintiff for the years 1961, 1962 and 1963. Stipulations of fact were filed by the parties and plaintiff introduced additional evidence at a trial held on November 22, 1965. The question is whether plaintiff need pay income taxes on funds received by him from the Trinity Petroleum Trust prior to the time the total payments exceed his basis in the Trust. This court holds that plaintiff must pay income taxes, subject only to the statutory depletion allowance.

The following facts are taken from the stipulations of fact filed by both parties. Trinity Petroleum Company,

hereinafter "Company", owned various oil and gas royalties in five states. Company organized Trinity Petroleum, Inc., hereinafter "Inc.", and on October 1, 1951, conveyed all its royalties to Inc. in exchange for 95% of all income received by Inc. from these royalties. Profits received on the other 5% would go to Company as Inc.'s sole owner should dividends be paid.

This same day Trinity Petroleum Trust, hereinafter "Trust," issued its 192,500 shares of beneficial interest to Company. Company distributed these shares in Trust to Company's shareholders in return for their 192,500 shares of Company.

These transactions left the following situation: Inc. held all the royalties. 95% of Inc.'s royalty revenue went directly to Trust. Any dividends declared by Inc. on the other 5% of its revenues also went to Trust.

Internal Revenue has insisted upon the following treatment of these proceeds: (1) Inc. passes 95% of its royalty income to Trust without taxation consequence. From the 5% it retains, Inc. deducts taxes paid, expenses, and 27½% *depletion* to compute its taxable income. (2) Trust deducts from its total receipts from Inc. taxes paid, expenses, and 27½% *depletion* on the 95% of royalties to compute taxable income. Insofar as Trust pays out to its shareholders an amount greater than taxable income, it pays no taxes. (3) The holder of shares of beneficial interest in the trust divides his receipts into three categories. That portion corresponding to Inc.'s dividends to Trust is taxable as ordinary income, depletion already having been allowed Inc. The remainder corresponds to the 95% paid directly to Trust by Inc. The share holder reports as ordinary income his portion of Trust's *taxable income* from the royalties. The

remainder is not taxable and it corresponds roughly to the depletion allowance claimed by Trust.

Plaintiff and his wife held as community property 6,152 shares of beneficial interest in Trust. Upon the death of plaintiff's wife on October 14, 1959, plaintiff became the sole holder of these shares. They were valued at $37 per share for federal estate tax purposes, and under Section 1014 of the Internal Revenue Code, $37 per share is now plaintiff's basis for all 6,152 shares.

Plaintiff received payments from Trust in 1961, 1962 and 1963 roughly totaling his proportionate share of all Trust's income in these years. Plaintiff did not include any of these proceeds in his income tax returns as taxable income. Plaintiff was subsequently assessed deficiencies as outlined above: (1) income corresponding to Inc.'s dividends to Trust taxable in full; (2) income corresponding to Trust's other *taxable* income taxable in full; (3) additional amounts corresponding to Trust's allowance for depletion not taxable. Plaintiff paid these assessments and instituted the present suit for refund.

I.

Plaintiff's basic position relies upon the Supreme Court case of Burnet v. Logan, 283 U.S. 404 (1931). The Supreme Court there held that when it is impossible to determine with fair certainty the fair market value of property held for the production of income, the owner may consider all returns to be returns of capital until he recoups his basis. After that, all sums received are ordinary income.

Plaintiff seeks to bring himself within this rule. He and his witnesses maintain that it is impossible to ascertain the value of the many royalties held by Inc., "many, many

tracts in 36 fields in 6 different states." Because Inc. does not have the power to acquire new leases, plaintiff claims it impossible to establish that his basis will ever be realized via the depletion allowances he now enjoys. There is opinion testimony that he never will recover his basis. At the rate of depletion allowed in the years in question, it would take over thirty years of similar production for the allowance to total up to his basis. With no new leases, plaintiff claims future production will decline.

From these facts and opinions, plaintiff concludes that recovery of his basis is far less certain than it was in the Logan case. There the taxpayer held the right to receive a specified interest in 60¢ per ton to be paid upon the extraction of ore from a mine. The future payment price, 60¢, was certain, and there was only one mine, containing non-fugitive minerals. Yet the Supreme Court said:

> "She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture." Burnet v. Logan, supra, 413.

Plaintiff maintains that the "conjecture" necessary in the Logan case is only slight compared to that necessary to value Inc.'s royalties. Consequently, he should pay no tax until his full basis of $37 per share is realized.

II.

Plaintiff has failed to establish the requisite uncertainty necessary to bring him within the Logan rule. A central factor relied upon by the Supreme Court was that it could not foretell with anything like reasonable certainty that the taxpayer would recover her capital investment.

> "Respondent might never recoup her capital investment from payments only conditionally promised." Burnet v. Logan, supra, at 413.
>
> "Some valuation—speculative or otherwise—was necessary in order to close the estate. It may never yield as much, it may yield more." Burnet v. Logan, supra, at 413-14.

The latter quotation was followed by an important analogy:

> "If a sum equal to the value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment." Burnet v. Logan, supra, at 414.

Certainly the distinguishing point about an annuity contract is that one never knows if the holder will live long enough to recoup his capital investment. The prospect of receiving income or interest is most uncertain. (It is interesting to note that despite this uncertainty, the Code *today* requires certain annuity payments to be apportioned between return of capital and income according to actuarial statistics. See Section 72 of the Internal Revenue Code.)

The Court of Appeals for the Sixth Circuit recently stated the rule of Logan to be:

> "Determination of the issue (whether income taxes are due before capital investment is recouped) turns on the question of whether the investment . . . is of such a speculative nature that the purchaser . . . cannot be reasonably certain of ever recovering his cost (citing Burnet v. Logan)." Darby Investment Corp. v. Commissioner, 315 F.2d 551, 552 (C.A. 6th, 1963).

Plaintiff cites two federal cases illustrating applications of Logan. Both cases strongly reinforce the crucial role in Logan of the certainty of return of capital. In Helvering v. Drier, 79 F.2d 501 (C.A. 4th, 1951), the taxpayer had been awarded damages plus interest, the annual payments of which were conditioned upon annual receipt by the United States of war debts from Germany. The court refused to consider any portion of payments made to be payments of interest (and thus taxable income) until plaintiff received the principal sum due.

> "Hence it has been doubtful ever since the award of 1929 was made whether the taxpayer ever would receive payment thereof in full. Under these circumstances, we agree with the Board that the case is governed by the rule in Burnet v. Logan . . ." Helvering v. Drier, supra, at 503.

In the second case relied upon by plaintiff, Axe v. United States, 191 F.Supp. 671 (D.Kan., 1961), the court applied the Logan rule because there was uncertainty as to whether any payment, capital or income, would ever be made.

In summary, Logan and subsequent cases clearly establish that before income taxes will be deferred until capital has been recouped, there must be uncertainty as to whether the taxpayer's basis will ever be recovered. Plaintiff's basis for his shares of beneficial interest in Trust is $37 per share. It is stipulated that plaintiff has received the following per share payments from Trust:

1960	$ 3.37
1961	3.755
1962	4.58
1963	4.97
1964	5.15

Payments for the five year period total $21.825 per share, well over one-half plaintiff's basis in the shares. The amount has increased each year. From these facts and the detailed information about the royalties presented to this court, this court holds that there is strong reasonable certainty that plaintiff will recoup his basis in the shares.

Plaintiff introduced evidence at the trial that he will never recoup his basis *through the deductions presently allowed plaintiff*. Plaintiff has at no time maintained that any uncertainty exists as to whether he will recoup his basis in the shares. The contention which plaintiff does advance relates to the function of the depletion allowance.

The deductions presently allowed plaintiff are essentially Trust's depletion allowance of 27½% on the 95% royalties it receives from Inc. Each year plaintiff excludes from taxable income an amount roughly corresponding to his proportionate share of Trust's depletion deduction and deducts it from his basis. This amount for plaintiff per share was:

1960	$ .99
1961	1.09
1962	1.32
1963	1.44
1964	1.50

The five year total was $6.34 and the amount has increased each year. At the average rate of $1.27 per year experienced in these five years, it would take plaintiff 24 more years to reduce his basis to zero. Plaintiff and his witnesses maintain this will never happen. In reality, plaintiff maintains that the 27½% apportionment is insufficient.

This court by no means accepts plaintiff's predictions. No holding on the matter is required, because Congress has

resolved such matters by the 27½% depletion allowance. Section 613 of the Internal Revenue Code.

Production from a single oil or gas well presents much the same difficulties of capital-income allocation as does Trust's "many, many tracts in 36 fields in 6 different states." The difficulties are both technical (how much oil reserve exists) and conceptual (whether the production of oil is a mere conversion of capital investment or an income producing operation). Congress resolved these difficult problems by providing the 27½% depletion allowance; 27½% of the oil or gas produced is not subject to taxation. The figure is arbitrary and represents a concession to the capital conversion aspects. Anderson v. Helvering, 310 U.S. 404, 406 (1940). It does not purport to reflect the precise or even closely approximate percentage of production which is capital conversion in a single tract, a thousand tracts, or even in the entire petroleum industry. It reflects only the existence of a capital conversion element in an arbitrary, but time-honored amount.

Certainly a taxpayer is not limited to the 27½% depletion figure. He may, for example, use cost depletion under Section 612 of the Internal Revenue Code. However, plaintiff seeks to escape the limitations of the 27½% depletion allowance by pointing to the very uncertainties which it exists to resolve. If plaintiff were to establish that it is uncertain as to whether he will ever recoup his basis, then Logan might apply and supplant depletion. However, plaintiff disputes something different, whether 27½% depletion will ever reduce his basis to zero. This does not bring Logan into play and only speaks to the proper apportionment of capital return and income. Plaintiff asserts that this alleged uncertainty entitles him to treat all revenues as returns of capital until he recovers his basis. Section 613 provides

that this uncertainty is resolved by the arbitrary allocation of 72½% income, 27½% principal.

Thus, Section 613 resolves difficulties of apportionment similar to those which called the Logan rule into play in the case of Inaja Land Company, Ltd., 9 T.C. 727 (1947), and Anton L. Trunk, 32 T.C. 1127 (1959).

Plaintiff also complains that he is allowed no depletion on his receipts from the dividends of Inc. Inc is allowed depletion on its royalties. Plaintiff cites no authority that a shareholder is entitled to depletion or depreciation of any kind on the assets of a corporation, nor has plaintiff pointed to a single instance where the Logan rule has been extended to a shareholder due to uncertainties concerning a corporation's assets.

III.

There is an additional fact which clearly demonstrates that plaintiff is not within the Logan rule. Shares of beneficial interest in Trust are regularly bought and sold "over-the-counter" through various brokers. Since 1959 the low for such shares has always been greater than plaintiff's basis of $37 per share. The high and low bid prices were:

	1960	1961	1962	1963	1964	9/15 1965
Low	38	49	52	58	83	91
High	45	52	58	83	96	96

Recent selling prices more than twice plaintiff's basis clearly reflect a virtual certainty that plaintiff will recover his basis by holding the shares of beneficial interest. They further tend to indicate that plaintiff will recoup his basis through depletion as well (a question which this court does

not decide). This is because market price is a form of valuation of the thing itself. These high market prices reflect the degree of certainty that plaintiff will receive payments in the future which will exceed his basis.

The market prices also perform a second and distinct role. They provide a means by which plaintiff can certainly recover his basis. Plaintiff can sell his shares. Of course, plaintiff is not required to sell his shares. This second point is that plaintiff has at hand a certain means of recovering his basis, which defeats the rule of Logan.

Courts have not always distinguished these two roles of market value—reflection of value and alternative means of recovering basis. However, the existence of a certain market value in excess of basis has always been held to remove the uncertainties relied upon in Logan.

In Chamberlin v. Commissioner, 286 F.2d 850 (C.A. 7th, 1960), cert. denied 368 U.S. 820 (1961), the court required that patent royalties be reported as ordinary income. Though the court relied on the view that Logan hinged on uncertainty as to return of capital (see part II of this opinion), not on a lack of ascertainable value, it found the sale of only twelve shares of stock in sixteen months to help establish ascertainable value. By contrast, as many as 8,514 shares in Trust have been sold in a single year.

In Darby v. Commissioner, supra, existence of a market value was heavily relied on to show that the taxpayer was reasonably certain to recover his investment. Two cases applying Logan were distinguished. In Phillips v. Frank, 295 F.2d 629 (C.A. 9th, 1961), the court said:

> "There is no evidence in the record that such rights had any market value . . . or any other value in excess

> of taxpayer's cost. There is no evidence in the record that taxpayer at any time could have sold such contracts at a profit. *The only source* from which he might reasonably expect to realize any part of his profit is from periodic payments subsequent to the return to him of his invested capital . . . A return of capital is not income." (emphasis supplied) Phillips v. Frank, supra, at 633-4.

The court relies here on market value as an alternative means of recovering capital which, if present, would defeat the application of Logan.

The second case distinguished was Willhoit v. Commissioner, 308 F.2d 259 (C.A. 9th, 1962). The court refused to hold that the taxpayer would probably realize more than his investment, noting that there was no market for the contracts involved.

In summary, the existence of a ready market price far above plaintiff's basis defeats the application of Logan in two ways: it establishes a virtual certainty that plaintiff will recover his basis through ownership of the shares, and it provides an alternative, certain means by which plaintiff can recover his basis. Even without consideration of this high market price, the evidence is sufficient to establish that the uncertainties relied upon in Logan are not present in plaintiff's situation.

Capital gain or loss is usually determined by liquidation.

Judgment will be entered for defendant. Clerk will notify counsel to draft and submit judgment accordingly.

JOE INGRAHAM
United States District Judge

APPENDIX B

United States Court of Appeals

FOR THE FIFTH CIRCUIT

October Term, 1966

No. 23,642

D. C. Docket No. 65-H-30-Civil Action

HOMER L. BRUCE, Appellant,

v.

UNITED STATES OF AMERICA, Appellee.

Appeal from the United States District Court for the Southern District of Texas.

Before TUTTLE, Chief Judge, AINSWORTH and DYER, Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Southern District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

January 10, 1967

Issued as Mandate:

APPENDIX C

STATUTES INVOLVED

SEC. 167. DEPRECIATION.

(a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business or

(2) of property held for the production of income.

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) GENERAL RULE.—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *"

SEC. 613. PERCENTAGE DEPLETION.

(a) GENERAL RULE.—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). *In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.* (Emphasis added.)

(b) PERCENTAGE DEPLETION RATES. — The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

APPENDIX D

EVIDENCE AS TO THE PROPERTIES INVOLVED

We call the attention of the Court first to petitioner's Exhibit No. 1 (R. 70). The original and nine copies are on file with this Court. It was stipulated that petitioner would be considered as having testified to the facts set out therein (R. 70). That exhibit takes up every one of the properties held by the Trust or Trinity Petroleum, Inc. The maps in that exhibit show in green the tracts in the various fields on which the royalties are located. The major portion of them is approximately a 1/72 overriding royalty on leases 192 and 193 from the State of Louisiana on certain of its waterways, including some of its properties out to the three mile limit in the Gulf of Mexico. That exhibit shows that the state leases referred to as "water bottoms" comprise the greatest part of the properties. Petitioner prepared a statement showing the income for 1960, 1961 and 1962 of the Trust and Trinity Petroleum, Inc., from the various classes of properties involved and it was introduced as Exhibit 2 (R. 74). The original and nine copies of Exhibit 2 are on file with the Court. It shows the following as to the percentage of the production from the properties:

	1960	1961	1962
Water Bottoms	88.094%	89.553%	89.370%
Other Louisiana	6.757	6.000	6.791
Texas	3.501	3.115	2.584
Others	1.648	1.332	1.255
	100.000%	100.000%	100.000%

In reference to those Louisiana properties petitioner testified (R. 74-75):

"Mr. Bruce: We offer that exhibit as Exhibit No. 2.

"Since they were of such importance, and I want to find out what I can do about getting an estimate of those, I went to the Gulf Oil Corporation in Louisiana, to Mr. Roy Payne, and he was in charge of all the Louisiana operations. Now, one of the fields over there is on the west, known as the West Bay Field. Now, Trinity Petroleum Company had an overriding royalty which Mr. Stuart Sherar negotiated, giving the one-seventy second overriding royalty on State Leases Number 192 and 193 from the State of Louisiana on waterways. Now, those go out three miles out into the Gulf and they are along navigable rivers, but it is extremely difficult to find out what is covered by water and what is covered by land. For instance, if water is a certain depth that has land there, two inches of water, that is land. Now, in the West Bay Field that was covered by Lease Number 192 and the adjoining land was under lease to Tidewater Oil Company. I knew of the unitization agreement that had been made between the Gulf Oil Corporation and the Tidewater, and I talked to Mr. Payne about it and he showed me this unitization agreement made about three years ago, and that shows that that unitization agreement covers 16 sands and the sands do not go over the whole field, and they were divided into 82 units and 363 tracts.

"Now, I asked Mr. Payne how much oil was in there. He said, 'Oh, Mr. Bruce, we took our organization four years to work this up, this information up,' and said, 'We don't know how much oil is there.'

* * *

"Mr. Bruce: Your Honor, on that, I put that in to show why when my investigation among people that are in the oil business, as to how I can go about getting an estimate. Mr. Payne in his verbal statements to me said that it did take them four years, and he said it would cost $500,000.00 to make an estimate of the oil.

> Under those circumstances I didn't even try. But to show the complications, I'm going to offer this unitization agreement as Plaintiff's Exhibit No. 3."

That Exhibit No. 3 is a unitization agreement of the West Bay Field in Plaquemines Parish, Louisiana, consisting of a 17 page contract, 16 pages of maps, and 82 pages of statistics on 16 sands and 329 tracts. The original is filed herewith but because of its length nine copies are not filed.

One of the biggest fields covered by lease 192 was in Timbalier Bay. We call attention to petitioner's Exhibit 4 (the original and nine copies of which are on file with the Court) and the lease arrangement and location of the wells as shown on page 128. The Court admitted that exhibit (R. 78). In addition in reference to that Timbalier Field Beatty, the Company's geologist, testified that there were over 480 different sands in the Timbalier Field and in reference to making an estimate he stated (R. 95):

> "In order to work these properties, make an estimate, it would take a number of years to do it. For instance, in the case of Timbalier with over 480 sands, your estimate for it, simply the calculations, would be approximately a day for each sand, and that would be most in working out the structure of the field; and it would take the other fields a proportionate length of time, it would be an inordinate amount of time, and when you get your answer it would be incorrect because of changing conditions."

Petitioner was the last president of Trinity Petroleum Company and has been attorney since then for the bank that is trustee under the Trust. He has received monthly statements from the Bank showing the income from the various properties and the date of the first runs from each. Exhibit 6 to the pre-trial stipulation (R. 34 and 56) is a

tabulation prepared by him of the production from each field by the Company up to January 1, 1952, and by Trinity Petroleum, Inc. and the Trust from that time through 1964. This shows that most of the fields have been in production since around 1938 or the early nineteen-forties. He testified (R. 83) that eight of the royalties had long since played out and ceased to produce and further testified that in his opinion he would never recover his $37 per share on the deductions being allowed him by the Government. (R. 78-79).

Sherar testified that he had been an engineering student at the University of Colorado and started out with an oil company in 1924 as a research geophysicist and in 1934 became the chief geophysicist of Carter Oil Company. He resigned in 1937 and was one of the organizers of Trinity Petroleum Company and as its president attended with Beatty to the purchase of all these properties (R. 84-85). He testified that he was thoroughly familiar with the above mentioned Exhibit No. 6 covering the production of all the properties. He stated that he had heard petitioner's testimony during the trial of this case.

He testified (R. 87):

> "Q. Do you think in your opinion as an expert would I get my $37.00 back?
>
> "A. I think, in analyzing a thing of this kind you've got to take into account the length of production. This is a factor that any buyer of royalties, which I am from my own account would take into account, that *I would say the answer is no.* (Emphasis added).
>
> "Q. Mr. Sherar, what was your opinion as to the ability of anyone to make a reasonably accurate estimate as to how much oil and gas would be produced from these properties if I attempted to compute my depletion on a cost basis?

"A. Mr. Bruce, I doubt very seriously that anyone would have the data or if they had the data would be able to analyze that. That is a continuing problem because these things change from time to time. I would think they would not be able to make a good evaluation of all these properties."

Beatty, whose testimony is set out in R. 91-98, testified that he had been a geologist all of his business life, that he had been the geologist for Trinity Petroleum Company and was familiar with these properties and in 1948 had made a detailed study of them. He testified that he was familiar with the Exhibit 6 showing the production of these royalties down through 1964. He then testified (R. 93-94):

"Q. You have heard my testimony that my basis for this 6,152 shares is $37.00 per share. On the basis that the Government so far has allowed me a deduction being 27-1/2% roughly of the royalties only that the trust gets, and with no deduction from the income by way of dividends from Trinity Petroleum, Inc., I would have to receive $827,236.36 before that 27-1/2% would allow me to recover my $37.00 per share. Based on your long experience as an expert geologist and familiarity that you have with these properties and the length of time that they have been producing, state whether or not under those circumstances it is your opinion I will be able to recover my $37.00 per share.

"A. No, sir."

He further testified concerning making an estimate of the production from these properties and arriving at a figure to be used for cost depletion (R. 95-96):

"Q. Let me say, Mr. Beatty, do you know that these are royalties in 36 fields in six states. State

whether or not as a geologist you think any reasonable estimate could be made of the amount of oil and gas to be produced on these properties on which you could base a cost depletion figure?

"A. No, sir. It could not. In order to work these properties make an estimate, it would take a number of years to do it. For instance, in the case of Timbalier with over 480 sands, your estimate for it, simply the calculations, would be approximately a day for each sand, and that would be most in working out the structure of the field; and it would take the other fields a proportionate length of time, it would be an inordinate amount of time, and when you get your answer it would be incorrect because of changing conditions. You have a number of things happening. Wells would go to water and change conditions, so it would be just a never-ending thing and you would never come up with an answer until the fields are exhausted.

"Q. State whether or not you have ever had to revise estimates you have made on different properties.

"A. I don't know anybody that hasn't had to. I know I have had to and I am not by any means alone in that."

APPENDIX E

HISTORY OF PROVISIONS FOR DEPRECIATION AND DEPLETION

Revenue Act of 1916

SEC. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be allowed as deductions—

* * *

Seventh. A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade;

Eighth. (a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow;

Revenue Act of 1918

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

* * *

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

* * *

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: * * * Provided further, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property

is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter;

Revenue Act of 1921

SEC. 214. (Same as in 1918 Act).

Revenue Act of 1924

SEC. 214. (a) In computing net income there shall be allowed as deductions:

* * *

(8) (Same as in 1918 Act).

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary.

Revenue Act of 1926

SEC. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½% per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, *except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.*

* * *

SEC. 214. (a) In computing net income there shall be allowed as deductions:

(8) (Same as in 1918 Act).
(9) (Same as in 1924 Act).

Revenue Act of 1928

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(k) (Same as in 1918 Act).
(l) (Same as in 1924 Act).

* * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * *

(b) Basis for depletion.—

* * *

(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—(Same as Sec. 214(a)(9) of 1924 Act).

Revenue Act of 1932

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(k) DEPRECIATION.—(Same as in 1918 Act).
(l) DEPLETION.—(Same as in 1924 Act).

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * *

(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross

income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, *except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.*

Internal Revenue Code of 1939

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(1) DEPRECIATION.—(Same as in 1918 Act).

(m) DEPLETION.—(Same as in 1924 Act).

* * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * *

(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, *except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.*

Section 23(l) of the Internal Revenue Code of 1939 as amended by Section 121 (c) of the Revenue Act of 1942

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * *

(1) DEPRECIATION. — A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or
(2) of property held for the production of income.

* * *

Revenue Code of 1954

SEC. 167. DEPRECIATION.

(a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or
(2) of property held for the production of income.

* * *

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) GENERAL RULE.—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *

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SEC. 613. PERCENTAGE DEPLETION.

(a) GENERAL RULE.—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). *In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.*

(b) PERCENTAGE DEPLETION RATES. — The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

27½% Depletion Provision

The 27½% depletion provision was inserted in Section 204 of the 1926 Revenue Act. The 1926 Act as introduced in the House did not have that provision but the Senate put it into Section 204. The report of the Senate Finance Committee on that point states (1939-1 (Part 2) Cum. Bul., Committee Reports, pages 345-346):

> "The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration your committee recommends that in the case of oil and gas wells the allowance for depletion shall be 25 per cent of the gross income from the property during the taxable year. The provision of existing law limiting this amount to an amount not in excess of 50 per cent of the net income of the taxpayer from the property is retained."

In the report to the House of the action of the Conference Committee it was stated (1939-1 (Part 2) Cum. Bul., Committee Reports, at page 362):

"Amendment No. 6: * * *

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"The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration the Senate amendment provides that in the case of oil and gas wells the allowance for depletion shall be 30 per cent of the gross income from the property during the taxable year. The provision of existing law limiting this amount to an amount not in excess of 50 per cent of the net income of the taxpayer from the property is retained.

"The House recedes with an amendment providing that the depletion deduction based upon gross income in the case of an oil and gas well shall be 27½ per cent of that income instead of 30 per cent, and in the case of mines the Senate amendment is changed to provide that discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit."